COMMENTS ON DRAFT AMENDMENT REGARDING CLASSIFICATION OF INCOME AS BUSINESS OR NONBUSINESS

By

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One Test v. Two Tests

I approve of the draft's declaration of two tests, a transactional test and a functional test, rather than a single transactional test. However, the courts of the several states are so badly split on this issue that I think uniformity can be achieved only by amending UDITPA § 1(a). In a significant number of UDITPA states, judicial precedent for the single-test interpretation will bar administrative approval of the dual-test approach of the draft.

A semanticist would probably say that the single-test view is the correct interpretation of the present UDITPA language. I can also say from personal knowledge that the drafters through the second clause (following the words "& includes") was intended to modify the first clause and not to create a separate test. The language was intended to synthesize California decisions dealing with rentals, patents, copyrights and interest on trade accounts receivable. In the California practice at that time (1950's), dividends were never treated as apportionable income, and the treatment of gains and losses on asset sales was unsettled. It is with respect to these latter classes of income that some courts have adopted the dual test interpretation in order to reach the result they considered reasonable under the facts of particular cases. I do not disagree with those decisions.

Business Income Presumptions

The presumption that all income is business income seems to me to reflect a market state bias within the MTC. If income is classified as business income and subjected to the apportionment formula, market states will get a piece of it because of the influence of the sales factor. Income classified as nonbusiness on the other hand, is likely to go entirely to corporate headquarters states because of the influence of commercial domicile in the allocation rules for nonbusiness income. I mention this not because I object to the presumption but because I think it may be unacceptable to non-member states and therefore may not achieve a high degree of uniformity.

I note that the presumption is invoked in new Example (vi) at line 323. I do not think presumptions should be cited in examples. Conclusions reached in examples should stand on solider ground. I would delete the first clause in the conclusionary sentence and rely on the second clause alone to support the conclusion.

A more serious problem is that the way the presumption is stated in Reg. IV.1.(a).2.B. makes it a one-way street. I believe that if presumptions are to be declared in matters of apportionment of income of multi-state businesses, there are constitutional implications which mean that the presumption must cut both ways. I would change the second sentence (line 52) to read, "A party seeking to overcome," etc.

Another presumption appears at lines 115-120, *viz.*, that income from property is business income if the taxpayer has taken a deduction from business income with respect to that property (*e.g.*, a depreciation deduction) or has included that property in the property factor. This is not a classic presumption; rather, it is an admission against interest. Therefore, it is appropriate that it is invoked only against the taxpayer and that there is no reverse presumption against the state.

Excessive Reliance On "Operational" And "Operative"

The draft makes repeated use of the terms "operational" and "operative" without defining them. "Operational" appears in three places (lines 101, 136, and 372), and "operative" also appears in three places (lines 275, 332 and 381).

The first use of "operational" (line 101) is to distinguish an operational function from an investment function. Later in the same paragraph, an investment function is adequately defined as something that serves the "mere financial betterment of the taxpayer in general." I suppose that anything that goes beyond this is operational in character. Perhaps a further definition of operational is unnecessary.

Where "operative" appears, it is always in the phrase "integral, functional, necessary, or operative." I am unable to think of anything that is operative that is not also integral and functional. Since these terms are linked by the disjunctive "or," I have to wonder if the draftsmen have something in mind that has a looser connection with the business than something that is integral or functional. If so, I would dissent. "Integral" appears in UDITPA itself and "functional" appears in a number of relevant court opinions, but "operative" has no such claim to legitimacy.

Adding A "Necessary" Test

I question the inclusion of the word "necessary" in the phrase "integral, functional, necessary, or operative component to the taxpayer's trade or business operations" as it appears in the examples on interest (line 275), dividends (line 332) and royalties (line 381). My reasons are:

1. It introduces a subjective test. Necessity is always a matter of opinion.

2. Can anything be necessary that is not also integral? If it can, then the regulation becomes a stealth amendment to UDITPSA § 1(a) which uses only the word "integral." (I recall that Idaho amended UDITPA to add "or necessary" after "integral," and the Supreme Court made note of this in ASARCO, 73 L.Ed. 2d 787, footnote 4).

It also seems to me that the phrase should read "component of" rather than "component to."

Relationship To Property Factor

The draft expresses a general correlation of the business/nonbusiness income determination and the inclusion/exclusion of property in the property factor. If property is includable in the property factor, the income it produces is business income (see, *e.g.*, lines 117-120 and lines 225-226). This is sensible, but there are several points at which this principle is either overstated or contradicted:

1. I object to the phrase that is proposed to be inserted in Reg. IV.1.(c).(2). Gain or loss from a sale of property is said to be business income if the property was used in the taxpayer's trade or business "or was otherwise included in the property factor of" ~~the~~ taxpayer's trade or business" (line 225). Under the clear wording of UDITPA § 10 there can be no "otherwise." Property can be included in the property factor only if it is *used* in the trade or business. There is nothing in Reg. IV.10. which supports the inclusion of property in the factor other than use. It may be that in a given case, inclusion of property in the numerator of the factor on a basis other than use within the state can be justified as a UDITPA § 18 adjustment (*e.g.*, to avoid apportioning income to a no-man's land), but I see no reason to anticipate that in this regulation which is intended to have general application.

2. In the same vein, I find something objectionable in Reg. IV.1.(c.)(1)., which is not proposed to be changed in this draft. It is stated that rents are business income if the subject property, "is used in the taxpayer's trade or business *or incidental thereto* and is therefore includable in the property factor under Reg. IV.10." (line 169). I find nothing in Reg. V.10. which authorizes inclusion in the property factor of property which is merely incidental to the taxpayer's trade or business. On the contrary, the concept of "incidental" conflicts with the rule of Reg IV.10.(a). that property which produces both business and nonbusiness income is to be included in the factor on a pro rata basis, not wholly included because it is incidental to the business.

Furthermore, the first definition of "incidental" in the Oxford English Dictionary is "casual, not essential." A casual, unessential connection of property to the unitary business does not justify inclusion of the property in the property factor nor treatment of gain on sale of the property as business income. I would strike the offending phrase from Reg. IV.1.(c).(1).

3. At lines 96-98 it is stated that income from a sale of property satisfies the functional test even after the taxpayer has left the trade or business in which the property had previously functioned. This statement conflicts with the general principle of the draft that there should be consistency between inclusion of property in the property factor and treatment of the property as productive of business income. The property factor rules would clearly compel that property be dropped from the factor when the taxpayer leaves the trade or business in which the property had been used, so why should income subsequently produced by that property be deemed business income?

I suspect the draftsman's authority for the statement at lines 96-98 was *Appeal of Fairchild Industries, Inc.*, Cal. St. Bd. of Equal., 8/1/80. The argument of consistency with the property factor was made by the taxpayer but brushed aside by the board because the property in question (a patent) was intangible and intangibles are never included in the property factor. I think this was a fatuous response to the argument; and if the case had involved tangible property, the decision might have gone the other way.

Dividends and Gains on Stock

Some of the most difficult cases on business v. nonbusiness income are those involving dividends from, and gains and losses on sale of, stock of another corporation. The cases are difficult because of the need to consider many subtle relationships between the two corporations going beyond the mere issuer — stockholder relationship. (They are also difficult cases because they give rise to the factor relief issue, something that is beyond the scope of the draft regulation).

The only guidance the draft offers on this particular subject is Example (iii) under Reg. IV.1.(c).(4). New Example (vi) under subsection (2) (lines 258-269) could furnish further guidance if language somewhat like this were added at the end:

> "If the division in the example had been a wholly owned subsidiary and the taxpayer had sold the stock, the gain would similarly be business income."

A way to simplify this difficult area would be for the MTC to pull back from the maximum apportionability which appears to be allowed by the Supreme Court in its *Allied Signal* opinion and adopt a rule that dividends and gains on stock are business income only where there is a unitary business relationship between issuer and holder, disregarding unity of ownership. That is, dividends and gains would be apportionable only where there is frequent intercourse between the two corporations but without requiring that the holder own more than 50 percent of the stock of the issuer. Such a rule would probably require an amendment of UDITPA because it would be a departure from some existing interpretations of current UDITPA language which could be cited as precedents by a party desiring a broader apportionability of this type of income.